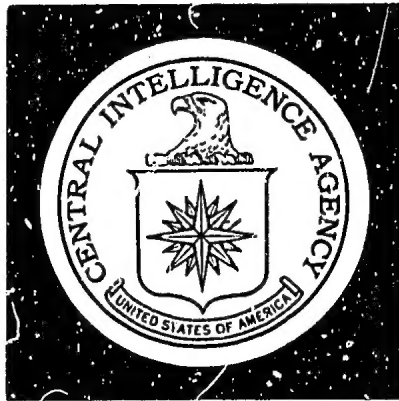


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**DIRECTORATE OF
INTELLIGENCE**

Intelligence Memorandum

Central American Common Market: Honduran Complaints

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CENTRAL INTELLIGENCE AGENCY

Directorate of Intelligence

August 1971

INTELLIGENCE MEMORANDUM

CENTRAL AMERICAN COMMON MARKET: HONDURAN COMPLAINTS

Introduction

1. December 1970 marked a watershed in the history of the Central American Common Market (CACM). Following the breakdown of year-long negotiations to restructure the market, Honduras unofficially withdrew by reinstating tariffs on imports from the other CACM members - Costa Rica, El Salvador, Guatemala, and Nicaragua (see Figure 1). The unprecedented move came after ten years of rapid but slackening growth in the countries' output and trade. Prominent in Honduras' list of complaints are chronic, growing deficits in intra-regional trade and lagging industrial development. Honduran grievances were intensified by the "hundred hour war" with El Salvador in July 1969. After two years, the countries still have not restored diplomatic relations and are not trading with each other officially. Although regionalism retains support among some Central American groups, Honduras' action raises doubts that the old market arrangements can be restored - and even that a five-nation grouping can be preserved. This memorandum examines the bases of Honduras' decision and considers its possible impact on Central American economic cooperation during the next few years.

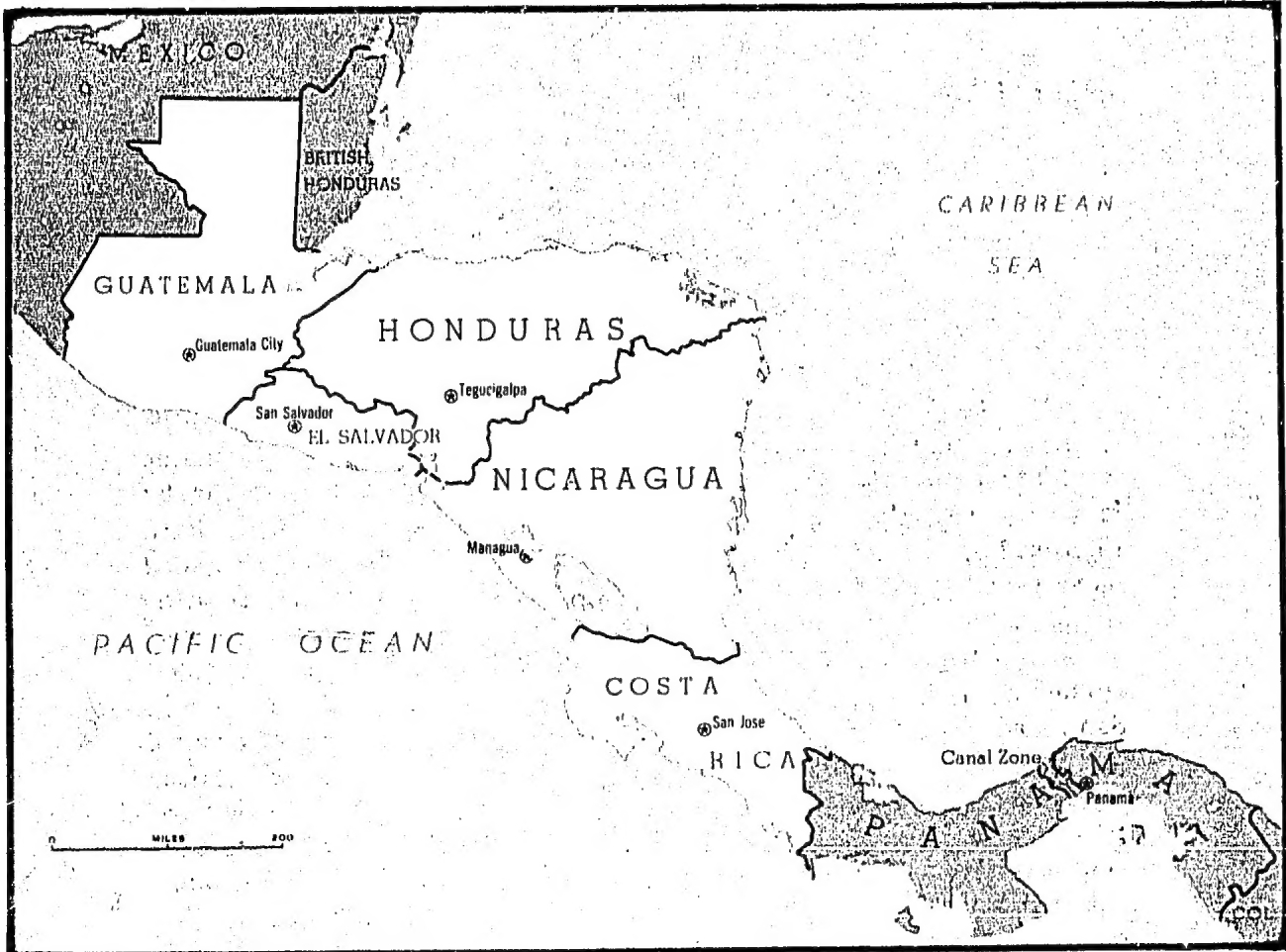
Discussion

Background

2. CACM was established in 1961 to "accelerate and balance" its members' economic development, as the General Treaty for Central American Economic Integration put it. As the least developed Central American country, Honduras probably attached greater significance than

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

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CONFIDENTIAL**The Central American Common Market (CACM)****Figure 1**

	Population, End of 1970 (Millions)	GNP Per Capita, 1970 (US \$)*	Exports, 1970 (Million US \$)
Honduras	2.6	300	172
Costa Rica	1.8	500	230
El Salvador	3.6	415	229
Guatemala	5.4	380	290
Nicaragua	2.0	465	179

*Estimated on a purchasing power parity basis.

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the other countries to the vaguely expressed goal of more balanced development and greater income equality within the region. This issue remained quiescent during CACM's first several years because the rapid growth of output, foreign trade, and government revenue in each country obscured the increasing disparities in development levels. By 1967, however, both Honduras and Nicaragua began to raise substantial objections to the CACM arrangement and call for its restructuring.

3. Honduran support of Central American integration was not particularly strong to begin with and has weakened since the early 1960s -- partly because the market obviously is no panacea and partly because of continuing ineffectual government. Dubious about the common market's benefits but afraid of being left out of the grouping, the Villeda Morales government (1957-63) carried Honduras along with the other four countries at the urging of some Honduran businessmen and economic technicians, the US government, and various international agencies. President Oswaldo Lopez' military government, which took office after a coup in 1963, was concerned primarily with maintaining itself in power. It treated CACM matters with benign neglect until 1969, when they became a major political issue because of the war and subsequent ending of trade with El Salvador. Lopez began to insist that CACM be restructured to aid Honduran development, and Ramon Cruz -- the new President inaugurated in June 1971 -- has maintained this hard line.

4. During the 1960s, CACM was periodically buffeted by members' departure from the rules or differing opinions about enlarging the sphere of cooperation. The truly damaging event, however, was the Honduras-El Salvador conflict in mid-1969. The underlying causes of the hostilities were the perennial border dispute, which had caused incidents previously, and the presence of several hundred thousand Salvadoran "colonizers" on Honduran territory. The spark for the conflict was set off by several soccer games between the two countries that were marked by riots and growing political tension. El Salvador invaded Honduras on 14 July and dealt its army a humiliating psychological defeat during the four days that passed before the Organization of American States obtained a cease-fire. Determined to resolve the border demarcation issue once and for all, the Honduran government has requested an international settlement of the dispute. On the basis of some sixteenth century Church documents concerning diocesan boundaries, Honduras claims about 53 square miles of territory that have long been under Salvadoran control.

Assessment of Honduras' Complaints

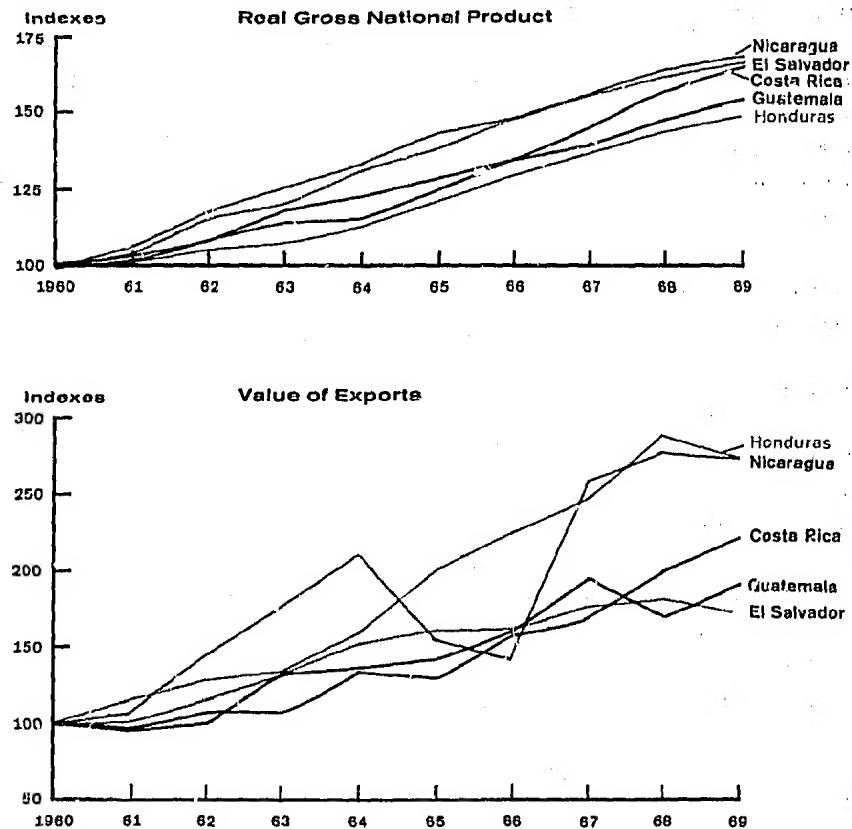
5. As far as economics is concerned, Honduras' dissatisfaction with CACM is based on an amalgam of fact, fancy, and naivete. The Honduran

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economic growth rate was indeed CACM's lowest in 1961-69 (see Figure 2), although the 5% average approximated the overall Latin American achievement. Complaints about how CACM has hampered industrialization and the growth of export earnings and of government revenues hardly seem to be justified, however. Hondurans clearly had exaggerated expectations of what the other members would do to equalize development levels and how far industrialization could progress in a decade. None of the five countries could realistically expect the economic upsurge following CACM's formation to be sustained indefinitely. Honduras' harsh criticism of CACM clearly has been encouraged by resentment against El Salvador and by the belief that a more assertive attitude toward intra-regional economic relations would pay off.

Central America: Growth in Output and Exports **Figure 2**



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6. Some of Honduras' bitterest complaints concern industrialization - not because progress was sluggish but because the country did not catch up with other CACM members. The 160% increase in manufacturing output in 1961-69 was second only to Nicaragua's gain and boosted the sector's share of Honduran gross domestic product from 10% in 1960 to 15% in 1969. The other countries also expanded output considerably, however, and at the end of the decade Honduras still had CACM's least developed manufacturing sector, as the accompanying tabulation shows. Honduras likewise made good progress in raising exports of manufactured goods, while continuing to trail the other countries in the share of earnings obtained from such sales.

	Percent			
	<u>Share of Manufac-</u> <u>turing in Gross</u> <u>Domestic Product</u>		<u>Share of</u> <u>Manufactures</u> <u>in Exports</u>	
	<u>1960</u>	<u>1969</u>	<u>1960</u>	<u>1969</u>
Honduras	10	15	12	30
Costa Rica	16	20	11	31
El Salvador	15	20	12	38
Guatemala	13	17	16	33
Nicaragua	12	18	15	35

7. More than in the other countries, manufacturing development in Honduras has been confined to traditional industries and new fields with simple technology. Honduras accordingly has come to dominate regional production only for such products as underwear, synthetic fabrics, soaps, and detergents. In the meantime, the other countries were pushing into somewhat more advanced manufacturing activities. Costa Rica, for example, developed a fertilizer plant with regional capacity, Guatemala established a large tire factory, and Nicaragua built a large chemical complex. Foreign investors, particularly US firms, financed \$250 million worth of this industrial expansion in CACM during 1960-69, including most new Honduran facilities designed to serve the regional market.

8. In some ways, it is surprising that Honduran manufacturing progressed as much as it did. Continued efforts to attract investment by providing tax exemptions met strong competition from the other countries. Programs for badly needed public investments in infrastructure were only partly realized. The small population (1.9 million people when CACM was

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formed), a poor transport system, severe shortage of skilled workers and managers, and reluctance of the few moneyed people to take business risks thus remained serious constraints on manufacturing expansion.

Foreign Trade

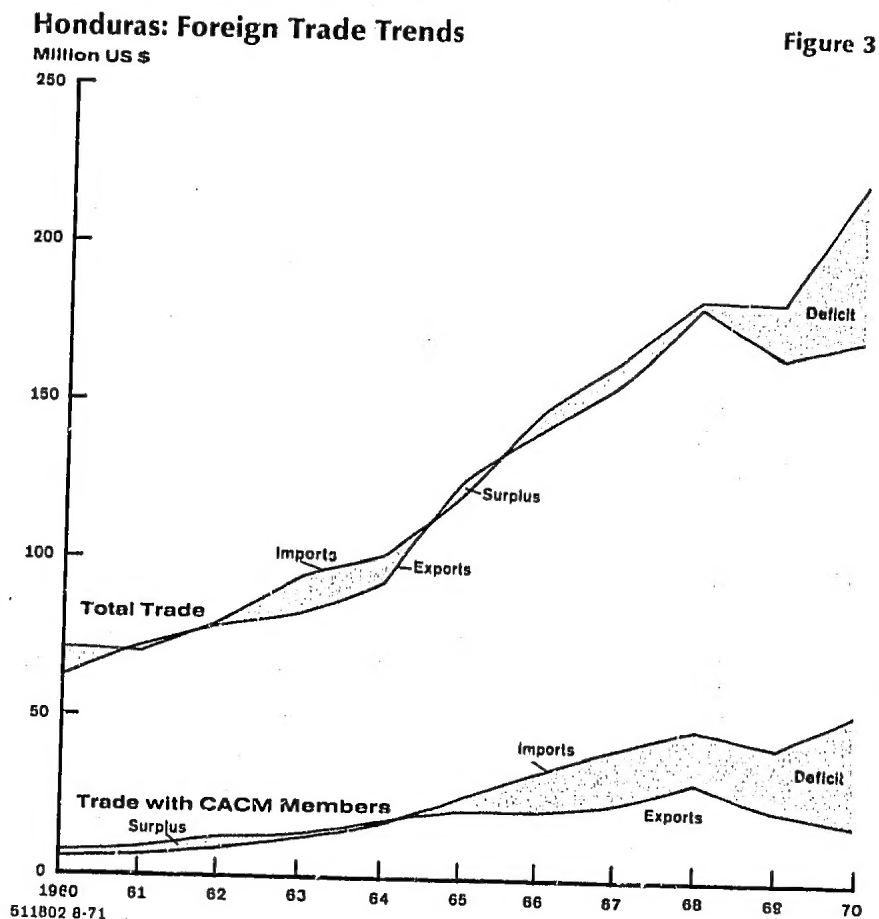
9. Honduran complaints regarding foreign trade center on export composition and the trade balance with CACM countries rather than on export growth. Indeed, Honduras had the region's most rapid export expansion during 1961-68, and despite a sharp setback in 1969, its record remained good (see Figure 2). This accomplishment owes much to increased sales to CACM countries, which rose from 12% of exports in 1960 to 18% during January-June 1969, before the war upset CACM trade. Although Honduras claims that it has remained primarily a raw material supplier for other CACM nations, sales to them largely accounted for the rise in deliveries of manufactured goods from 12% of exports in 1960 to 30% in 1969. This share would have increased even more if prices for bananas, the main export to non-CACM nations, had not been considerably higher at the end of the period than at the beginning.

10. Balance-of-payments difficulties have become significant only since 1969 and are an outgrowth of the hostilities with El Salvador and the adverse effects of Hurricane Francelia on agricultural production. Although Honduras generally had small trade deficits in the 1960s (as in the 1950s), these did not prevent a moderate rise in foreign exchange reserves. At an average of \$14 million annually, Honduras' deficits in CACM trade were considerably larger than those of any other member. But they generally were offset by trade surpluses with other countries - notably the United States and West Germany - and by capital inflows from the United States.

11. The conflict with El Salvador widened the deficit in regional trade to \$37 million in 1970, while reduced exports of bananas and coffee caused a deficit with non-CACM countries for the first time since 1964 (see Figure 3). With an overall trade deficit equaling 22% of imports and a slide in foreign reserves from \$30 million to \$20 million during the year, the Lopez government decided in December to cut back imports from CACM members by subjecting them to regular tariffs. In response, the other four countries promptly levied special charges on imports from Honduras. These charges - euphemistically called "import bonds" - are equal to the Honduran duty on imports of the same product from the other CACM members.

12. Bankruptcies, factory relocations, and cutthroat competition among the remaining four CACM members have followed the Honduran withdrawal. The trade crisis among the four is now at the point where

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replacement of market-wide arrangements by bilateral trade agreements with Honduras is officially acknowledged as inevitable. Meanwhile, during the first half of 1971, Honduras considerably reduced its trade deficit with CACM countries, at the cost of declines of 76% in imports and 59% in exports from the corresponding period in 1970. At the same time, traditional exports to other areas did well, and a moderate overall trade surplus was achieved.

Growth of Government Revenues

13. Another Honduran complaint against CACM is that regional free trade hurt government revenues by reducing import taxes. In real terms, the growth of Honduran government revenues was about average for the

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area - a respectable accomplishment considering that output expanded less rapidly than in the other countries. Moreover, Honduras was the only country of the five to achieve an increased ratio of central government revenues to total output during the 1960s, as the following tabulation shows:

	Government Revenues as a Percent of GDP			
	<u>1960</u>	<u>1967</u>	<u>1968</u>	<u>1969</u>
Honduras	11.8	11.8	12.7	12.5
Costa Rica	15.5	11.8	12.6	12.9
El Salvador	12.0	10.2	10.2	11.6
Guatemala	10.5	8.5	8.7	8.9
Nicaragua	9.8	10.6	8.9	9.3

Although Honduran import tax receipts lagged behind the value of total output, sales and income tax revenues each rose more rapidly than output. Much of the rise in revenues came from taxes on liquor, beer, and petroleum products - goods previously imported from outside the region but now purchased largely within CACM.

Regional Cooperation

14. One of the common market's attractions was the prospective lessening of the enormous US influence in the area, but Honduras has found that dealing with its CACM partners also presents difficulties. Even in matters promising economic gains mostly at the expense of extra-regional interests, disputes typically have arisen about sharing the benefits. In several instances, harmony has been disturbed by actions taken by one country in response to pressing domestic problems. Because of dissatisfaction with CACM's operation and its aggrieved feelings about the 1969 war, there is now little willingness on Honduras' part to subordinate immediate national interests for the region's long-term economic good.

Implications for the Common Market

15. At least some of Honduras' complaints about how it has been ill-served by CACM obviously are poorly founded. But many Hondurans see the criticisms as valid and, in any case, are strongly inclined to subordinate economic matters to the emotion-laden border dispute. The Cruz government has set two major conditions for Honduras' renewed participation in CACM. The first one, stated baldly, is that CACM

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arrangements be modified to insure that the Honduran economy outpaces the others, thereby narrowing the gap in development levels. The second, which President Cruz insists must be considered concurrently, is resolution of the border demarcation problem. There is no reason whatsoever to suppose that Honduran development is a priority objective of the other four countries, and prospects for settlement of the border issue any time soon are extremely bleak. Politically, the Salvadoran government cannot afford even to consider giving up the disputed territory, except perhaps in exchange for another area. Moreover, the area is important economically because of the country's high population density. Although there have been reports that El Salvador might be willing to swap the land in question for El Tigre, an island in the Gulf of Fonseca that it claims on the basis of colonial documents, it is doubtful that Honduras would give up its only port on the Pacific.

16. Although deteriorating economic performance conceivably could persuade Honduras to modify its demands concerning CACM, there are few signs that such pressures will appear in the near future. The strong market for Honduran bananas has substantially increased export earnings so far this year despite the sharp drop in sales to CACM members. So long as banana exports remain favorable, the Cruz government probably will not have any compelling reasons to join the other countries in restoring free intra-regional trade. Honduras may, however, agree to bilateral arrangements that would promise reasonably balanced trade.

17. Economically, there is little reason why CACM could not survive Honduras' defection. The market was very small and narrowly developed even as a five-nation grouping, and for four members it would be only a little less beneficial than before. The main significance of Honduras' action lies in the question raised about CACM's long-term political feasibility -- not in whether a four-country market is viable. There is now more doubt than before that CACM can withstand the national economic strains and international conflicts that are bound to arise occasionally. Political support for CACM clearly is not as strong as was once believed, and Honduras' action may well prove to have set off a process of dissolution.

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